BEFORE THE ARIZONA DEPARTMENT OF REVENUE

In the Matter of	)	**DECISION OF HEARING OFFICER**
[REDACTED]	)	
	)	**Case No. 200600091-C**
FEIN [REDACTED]	)	

[REDACTED] (Taxpayer) requested that this matter be resolved through the submission of written memoranda. Taxpayer timely filed its opening memorandum by postmark dated December 11, 2006. The Corporate Audit Section (Section) of the Arizona Department of Revenue (Department) timely filed its response memorandum on February 20, 2007. Taxpayer timely filed its reply memorandum by postmark dated May 1, 2007. Therefore, this matter is ready for ruling.

FINDINGS OF FACT

The parties' joint listing of facts establishes the following. [REDACTED] is incorporated in [REDACTED], [REDACTED]'s executive offices are located in [REDACTED] and [REDACTED] is its commercial domicile. Taxpayer develops, manufactures, markets, distributes and services [REDACTED] that helps customers manage and grow their businesses.

Taxpayer filed combined Arizona income tax returns for the years at issue. The Section audited Taxpayer for tax years ending May 31, 1996 through May 31, 2000 and issued a proposed assessment for these years that included tax and interest. No penalties were imposed. Taxpayer timely protested the assessment. The Section subsequently modified the assessment

several times. Taxpayer and the Department subsequently entered into two partial closing agreements. The parties agree that the remaining issue involves the classification by Taxpayer as nonbusiness income the gains arising from sales of common stock of a majority-owned overseas subsidiary, [REDACTED].

[REDACTED] was incorporated in [REDACTED] and has conducted business operations in [REDACTED]. The [REDACTED] trade name and trademarks are used in [REDACTED] under license to [REDACTED].

[REDACTED] is a wholly owned subsidiary of [REDACTED]. [REDACTED] is incorporated in [REDACTED] and is included in the federal corporate income tax return of [REDACTED]. [REDACTED] is a holding company that holds the common stock of [REDACTED]. [REDACTED] was included in Taxpayer's Arizona combined corporate income tax returns for the years at issue.

Until [REDACTED], [REDACTED] owned [REDACTED]% of [REDACTED]. The remainder was owned by [REDACTED] employees ([REDACTED]%), [REDACTED] ([REDACTED]%) and [REDACTED] (.[REDACTED]%). In February, 1999 [REDACTED] sold [REDACTED]% of [REDACTED] on the [REDACTED] over-the-counter market and retained an [REDACTED]% ownership. For tax year ending [REDACTED] Taxpayer classified the gain recognized by [REDACTED] of $[REDACTED] as nonbusiness income on the Arizona return.

In [REDACTED], [REDACTED] sold an additional [REDACTED]% of the outstanding shares of [REDACTED] on the [REDACTED] Stock Exchange and retained a [REDACTED]% ownership share. For tax year ending [REDACTED], Taxpayer classified the gain recognized

by [REDACTED] of $[REDACTED] as nonbusiness income on the Arizona return.

A significant portion of the proceeds from the sales of stock of [REDACTED] was lent by [REDACTED] to [REDACTED]. These proceeds were used by [REDACTED] to buy back [REDACTED] common stock listed on the [REDACTED] in the United States.

The issue to be decided is whether the gains arising from the sale by [REDACTED] of the common stock it owned in [REDACTED] constitute business or nonbusiness income. In its assessment, the Section determined that this income is business income to be apportioned to Arizona. Taxpayer argues that [REDACTED], as a holding company, is not engaged in business activities and thus is not operationally integrated with Taxpayer and as such [REDACTED] and its gains from the sales of the [REDACTED] stock are not to be included in the Arizona combined return. Alternatively, Taxpayer argues that the gain is nonbusiness income, not to be apportioned to Arizona. Taxpayer argues that Arizona's version of the Uniform Division of Income for Tax Purposes Act sets forth only a transactional test for determining whether income is taxable as business income, and not a separate and independent functional test. Additionally, Taxpayer argues that the Department's attempt to treat the gain as apportionable business income is unconstitutional in that it violates the fourth prong of the test set forth by the United States Supreme Court in *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274, 279 (1977).

References herein to the Arizona Administrative Code (A.A.C.) are to the Code as it existed during the years at issue.

CONCLUSIONS OF LAW

The presumption is that an additional assessment of income tax is correct and the burden is on the taxpayer to overcome such presumption. *Arizona State Tax Commission v. Kieckhefer,* 67 Ariz. 102, 191 P.2d 729 (1948). The United States Supreme Court has held that a taxing authority's apportionment formula is not to be disturbed unless the taxpayer proves by clear and cogent evidence that the income attributed to the state has led to a grossly distorted result or is in fact out of all appropriate proportion to the business transacted in that state. *Hans Rees' Sons v. North Carolina,* 283 U.S. 123 (1931); *Norfolk & Western Railway Co. v. Missouri State Tax Commission,* 390 U.S. 317 (1968); *Moorman Mfg. Co. v. Bair,* 437 U.S. 267 (1978). Taxpayer has failed to show that the Section's application of Arizona's allocation and apportionment provisions does not fairly represent the extent of Taxpayer's business activity in Arizona or that it produces incongruous results. Taxpayer has failed to prove that the income attributed to Arizona has led to a grossly distorted result or is in fact out of all appropriate proportion to the business transacted in Arizona.

A.R.S. § 43-102.A.5 states in part that it is the intent of the legislature to impose on "each corporation with a business situs in this state a tax measured by taxable income which is the result of activity within or derived from sources within

this state." A.R.S. § 43-307.A provides in part that "[e]very corporation subject to the tax imposed by this title shall make a return to the department." A.R.S. § 43-942 authorizes the Department to require the filing of a combined report in the case of two or more corporations owned or controlled directly or indirectly by the same interests in order to prevent evasion of taxes or to clearly reflect income.

As previously noted, [REDACTED] was included in Taxpayer's Arizona combined corporate income tax returns for the years at issue. However, Taxpayer now argues that [REDACTED], as a holding company, is not engaged in business activities and thus is not (and cannot be) operationally integrated with Taxpayer. As such, Taxpayer argues, [REDACTED] and its gains from the sales of [REDACTED] stock are not to be included in the Arizona combined returns. Alternatively, Taxpayer argues that the gains constitute nonbusiness income, not apportionable to Arizona.

As to the unitary business issue, A.A.C. R15-2-1131.E provides in pertinent part:

> * * *
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> 1. Single unitary trade or business and a combined report. The determination of whether the activities of the taxpayer constitute a single trade or business or more than one trade or business will turn on the facts in each case. In general, the activities of the taxpayer will be considered a single unitary business if there is evidence to indicate that the basic operations of the components under consideration are integrated and interdependent.

The following definition of a single unitary business is based on economic substance and not form. Therefore, a unitary business may consist of one corporation or many corporations. If the unitary business consists of more than one corporation, a combined report by the entities comprising the unitary business is required by the Department. Components of the combined report must reconcile accounting periods and systems if they are not compatible. See R15-2-1132(E) and (F) for methods of filing a combined report and reconciling incompatible accounting periods. The entities comprising the unitary business must be united by a bond of direct or indirect ownership or control of more than fifty percent (50%) of the voting stock of a subsidiary corporation. There must be common management of the component parts or entities. At least some part of the unitary business must be conducted in Arizona.

The fundamental reason for defining a business as unitary is that its components in various states are so tied together at the basic operational level that it is truly difficult to determine the state in which profits are actually earned. Centralized top-level management, financing, accounting, insurance and benefit programs or overhead functions by a home office are not sufficient characteristics in themselves for a business to be unitary without further analysis of the basic operations of component businesses.

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While common ownership, common management and reconciled accounting systems of components are necessary threshold characteristics for a business to be considered a single unitary business, the presence of these three characteristics is not sufficient without evidence of substantial operational integration . . .

The rule then lists several factors of a single unitary business which indicate basic operational integration. The rule states that all of the "factors need not be present in every unitary business, but factors indicating substantial integration at the basic operational level should be evident."

The evidence indicates that with regard to Taxpayer and [REDACTED], the threshold characteristics of common ownership, common management and reconciled accounting systems are present. Additionally, Exhibit 1 attached to the Section's response memorandum, which is a copy of a letter [REDACTED], discusses several factors that indicate substantial integration at the basic operational level between [REDACTED] and the other entities that constitute Taxpayer. Some of those factors include: 1) [REDACTED], 2) [REDACTED], 3) [REDACTED] and 4) [REDACTED]. The letter states that [REDACTED].

The information in this letter [REDACTED] is clearly indicative of a substantially interdependent and integrated business at the basic operational level. Insufficient evidence has been presented to conclude that [REDACTED] is not a part of this interdependent, integrated unitary business discussed in the letter. It is therefore concluded that the Section has provided sufficient proof to establish that [REDACTED] is an integrated part of Taxpayer's unitary business and therefore must be included in Taxpayer's combined Arizona income tax returns for the years at issue.

As previously noted, Taxpayer argues in the alternative that [REDACTED]'s gains from its sales of [REDACTED] stock

constitute nonbusiness income which is not apportionable to Arizona. A.R.S. § 43-1139 provides that all business income shall be apportioned to Arizona by using an apportionment formula consisting of the property factor, the payroll factor and the sales factor. A.R.S. § 43-1134 provides that capital gains, to the extent they constitute nonbusiness income, shall be allocated pursuant to A.R.S. § 43-1136.

A.R.S. § 43-1131.1 defines "business income" to mean:

> **. . . income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.**

A.R.S. § 43-1131.4 defines "nonbusiness income" to mean all income other than business income.

A.A.C. R15-2-1131.A provides in pertinent part:

> **Business and non-business income defined. "Business income" is income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations. . . In essence, all income from the conduct of trade or business operations of a taxpayer is business income. For purposes of administration, the income of the taxpayer is business income unless clearly classified as non-business income.**
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> **"Non-business income" means all income other than business income.**

Arizona law, at A.R.S. § 43-1131.1 and A.A.C. R15-2-1131, provides two alternative tests to determine whether income constitutes business income. The first is the "transactional test" under which the question is whether the activity or transaction which gave rise to the income occurred "in the regular course of the taxpayer's trade or business." The second test is the "functional" test. Under this test, income is business income if "the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." For instance, A.A.C. R15-2-1131.B.1.b provides that gain or loss from the sale of assets and gain or loss from the sale, exchange or other disposition of real or tangible or intangible personal property "constitutes business income if the property while owned by the taxpayer was used in the taxpayer's trade or business." Clearly, this is a functional test. Also *see* CTR 94-12 which discusses the transactional and functional tests in determining what is business and nonbusiness income for an Arizona affiliated group that files an Arizona consolidated income tax return. It is well settled that an agency's interpretation of a statute is entitled to great weight. *Marlar v. State*, 136 Ariz. 404, 666 P.2d 504 (App. 1983). Clearly, Arizona has adopted both the "transactional" test and the "functional" test.

As previously noted, A.A.C. R15-2-1131.B.1.b addresses gain or loss from the sale of assets and gain or loss from the sale, exchange or other disposition of real or tangible or intangible personal property. A.A.C. R15-2-1131.B.1.b provides:

> **Gains or losses from sales of assets, gain or loss from the sale, exchange or other disposition of real or tangible or intangible personal property constitutes business income if the property while owned by the taxpayer was used in the taxpayer's trade or business. However, if such property was utilized for the production of non-business income or otherwise was removed from the property factor for a substantial period of time before the year of its sale, exchange or other disposition, the gain or loss will constitute non-business income. Five years or more shall be considered a substantial period of time.**

The evidence shows that the purpose of [REDACTED] was to hold and sell the common stock of [REDACTED]. This was the business of [REDACTED], and this is in fact what [REDACTED] did during the years at issue. Therefore, pursuant to A.R.S. § 43-1131.1 and A.A.C. R15-2-1131, [REDACTED]'s gains from sales of the common stock it owned in [REDACTED] is apportionable business income under the functional test. Taxpayer has produced insufficient evidence to the contrary.

Taxpayer argues that the Department's attempt to treat the gain as apportionable business income is unconstitutional in that it violates the fourth prong of the test set forth by the United States Supreme Court in *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274, 279 (1977). In *Brady,* the United States Supreme Court observed that a state tax is constitutionally

valid if the tax satisfies the following four-prong test: 1) it is applied to an activity with a substantial nexus with the taxing state, 2) it is fairly apportioned, 3) it does not discriminate against interstate commerce and 4) it is fairly related to the services provided by the state. However, *Brady* addressed a Mississippi tax on the privilege of doing business in the State and did not address apportioning among states income of a unitary business.

Unlike *Brady*, in *Container Corporation of America v. Franchise Tax Board,* 103 S.Ct. 2933, 2940 (1983) the United States Supreme Court addressed apportioning among states income of a unitary business, which is more on point in the present case. In *Container Corporation*, which was decided several years after *Brady*, the Court observed:

> **The Due Process and Commerce Clauses of the Constitution do not allow a State to tax income arising out of interstate activities- even on a proportional basis- unless there is a " 'minimal connection' or 'nexus' between the interstate activities and the taxing State, and `a rational relationship between the income attributed to the State and the intrastate values of the enterprise.'". . . At the very least, this set of principles imposes the obvious and largely self-executing limitation that a State not tax a purported "unitary business" unless at least some part of it is conducted in the State . . . It also requires that there be some bond of ownership or control uniting the "unitary business." . . .**
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> **In addition, the principles we have quoted require that the out-of-State activities of the purported "unitary business" be related in some concrete way to the in-State activities. The functional meaning of this requirement is that there be some sharing or exchange of value not capable of precise identification or**

> measurement- beyond the mere flow of funds arising out of a passive investment or a distinct business operation- which renders formula apportionment a reasonable method of taxation. (Citations omitted.)

A.A.C. R15-2-1131.E accordingly provides in part that "[a]t least some part of the unitary business must be conducted in Arizona."

It is undisputed that at least a part of Taxpayer's unitary business was conducted in Arizona during the audit period and that there was some bond of ownership or control between the entities included in the assessment. There is insufficient evidence to conclude that the income at issue arose out of passive investments or from distinct business operations. The Court, in *Container Corporation*, pointed out the taxpayer has the burden of showing by clear and cogent evidence that the state tax results in extraterritorial values being taxed. Taxpayer has provided insufficient evidence to prove that extraterritorial values are being taxed by Arizona in this instance.

Based on the foregoing, Taxpayer's protest is denied.

DATED this 14th day of May, 2007.

ARIZONA DEPARTMENT OF REVENUE
APPEALS SECTION

[REDACTED]
Hearing Officer

Original of the foregoing sent by
certified mail to:

[REDACTED]

Copies of the foregoing mailed to:

[REDACTED]

Copy of the foregoing delivered to:

Arizona Department of Revenue
Corporate Audit Section